No. 10274

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

SEATTLE RENTON LUMBER COMPANY, a corporation, *Appellant*,

vs.

UNITED STATES OF AMERICA, *Appellee*.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF WASHINGTON, NORTHERN DIVISION

REPLY BRIEF

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SUMMARY OF ARGUMENT

The objections raised by appellee to the manner in which appellant corporation transferred its business to a partnership are without substance, and even if they were well founded, would only render the transfers voidable at the instance of dissenting shareholders, of which there were none in this case, unanimous consent of the shareholders being clearly shown.

Appellee's second objection, that no partnership was formed to take over the business, is not supported either by the law or the facts, the record showing conclusively that a partnership was formed and oper-

ated the business the last six months of 1933. Appellee further argues that substance, not form, should determine tax liability, and yet, in this action where the record shows that in *substance*, the corporation transferred its business and the partnership operated it, appellee has raised only technical objections to the form by which the change was effected.

ARGUMENT

1. The objections raised by appellee to the manner in which appellant corporation transferred its business to a partnership are without substance, and even though they were well founded, would not render the transfer void, as has been alleged in appellee's brief, but only voidable at the instance of *dissenting* shareholders.

Appellee cites numerous cases and authorities to support its contention that a majority of the shareholders or directors of a corporation have no power to sell all the assets of a corporation without the unanimous consent of all the shareholders. The cases cited all involve transactions where a majority of the shareholders or directors sought to sell the assets of a corporation to some third person or to the majority shareholders themselves. In none of the cited cases was the question of a transfer of the assets to all of the shareholders as a partnership involved. In the cases cited, the rule is usually stated that a sale of all the assets of a corporation to a third person cannot be made against the dissent of a shareholder.

In *American Seating Co. v. Bullard* (C.C.A. 6) 290 Fed. 896, the court said that a sale of all the assets

of a corporation could not be made against the *dissent* of a shareholder. *Des Moines Life & Annuity Co. v. Midland Ins. Co.* (Minn.) 6 F.(2d) 228, also used the word "dissent" in stating the rule regarding the sale of all the assets of a corporation.

Turning to the Washington cases, we find that a corporation has inherent power to sell real or personal property, *Milton v. Crawford*, 118 Pac. 32, 65 Wash. 145, and the sale by it of all its assets is not *ultra vires*, but subject only to the restriction that the sale be not in fraud of the rights of shareholders. *Cardiff v. Johnson*, 218 Pac. 269, 222 Pac. 902, 126 Wash. 454.

The rule as to the power of a corporation to dispose of all its assets is stated in this latter case at page 461 of the Washington Report as follows:

> "We should always adhere to the principle that the property of a going, solvent corporation could not be disposed of by a majority of the stockholders *over the protest of a single stockholder*, in order to get rid of the dissenting shareholder."

From the above cases it is apparent that the disposal of all the assets of a corporation is not *ultra vires* and clearly not against public policy.

The applicable public policy and the necessity for positive objection by a shareholder to set aside a transfer such as is involved in this case is stated in Fletcher's Cyclopedia of Corporations, Permanent Edition, Vol. 6, Page 1023, Ch. 36, Sec. 2943:

> "That the state cannot raise objection to a transfer of all its property by a purely private, as distinguished from a quasi-public corporation seems to admit of no doubt. Thus, in an early

> case in California, the court said: 'The only interest the public has in the continuance of the business is the remote, general interest, which it has in the proper development of the resources of the country. * * * If it is found from experience that the interests of the corporation and creditors require that the business should not be carried on upon so large a scale, or that it should cease entirely, and the disposal and conveyance of a part or the whole of the property is necessary to a reduction or cessation of business, and the stockholders consent, *or do not object*, we know of nothing in the statute, or in sound public policy, to prevent the sale or conveyance for such purpose. * * * The interests of business men, and of the public, must necessarily coincide, for the prosperity of the state is but the aggregate of the prosperity of its citizens.' "

In the case at bar, all of the beneficial owners of stock were consulted on the contemplated change from a corporation to a partnership to be made at the time the annual profit and loss statement was to be taken off (R. 53, 57), and all gave their approval to the plan. All were given notice of a special meeting for the express purpose of making a change from a corporation to a partnership (R. 58, 59), and yet not one shareholder ever made any sort of objection. Since there were no dissenters, of course the rule cited in appellee's brief is inapplicable.

The shareholders' meeting was, of course, regularly and lawfully held. The notice stated that the meeting was to be held at the mill office (R. 59). On the day of the meeting Mr. Roberts and Mr. Carlson spent the greater part of the day at the office putting

the books in shape for the contemplated transfer to the partnership (R. 60), and apparently no one else appeared or desired to attend the meeting. Mr. Roberts and Mr. Carlson owned over half of the shares and would, no doubt, have formed a quorum for the meeting. However, it appears that the meeting was adjourned (R. 65) to the law office of Weter, Roberts & Shefelman in order that Mr. Weter could participate in the meeting. The record shows that all interested parties were advised of the meeting and had an opportunity to attend. There is not the slightest suggestion that the change of the meeting place was made in order to conceal the actions of the participants, but on the contrary to enable a larger number of shares to be represented at the meeting. Of course, had the meeting been held at some secret place to the injury of shareholders who desired to participate, then those shareholders would have an opportunity to protest the validity of the meeting and, had they not ratified the acts of the officers, could bring an action for appropriate relief. However, such a rule has no application whatsoever to the facts in this case where no one suffered any injury, where everyone had an opportunity to attend, and where the expressed purpose of adjourning to another meeting place was to enable additional stock to be represented.

With appellee's contention that there was no consideration for the transfer of the corporate assets to a partnership, inconsistent theories are presented by its brief. Appellee first contends that the transfer was void because it was a sale without unanimous consent of the shareholders, and then argues that

there was no sale at all because the transaction was but a liquidating dividend. The argument presenting the question of consideration passing from corporation to partnership is indeed misleadng, for questions of contract are not involved in the action. The issue here is whether the assets were transferred from the corporation to the partnership and whether the partnership thereafter operated the business. Of course no money actually changed hands, but the essence of the transaction was that the shareholder's interest in the corporation was exchanged for his interest in the partnership (R. 62 to 79).

Appellee also questions the validity of the assumption clause in the deed executed by the corporation, the theory of appellee's argument apparently being that the clause is too indefinite to be enforcible, and hence the transfer is without consideration. It is readily apparent that the transfer of the land and personal property was part of the same transaction, which was supported by valid consideration (R. 62-69).

2. In contending that no partnership was created at all in this case, the appellee, rather than consider the local law applicable to the question, states in its brief that, "the revenue law prescribes its own tests for the existence of a partnership; local law is not controlling." This statement is not borne out by the cases cited. The case of *Wholesalers Adjustment Co. v. Commissioner* (C.C.A. 8) 88 F.(2d) 156, and *George Brothers & Co. v. Commissioner*, 41 B.T.A. 287, both involved not the creation of a partnership, but the

classification of a business organization for tax purposes. In both of the cases the question presented was whether a given organization was to be *classified* as an association subject to corporate taxes, or a partnership. The rule stated is that the question of *classification* for tax purposes depends upon the construction of the federal law. In other words, an organization might be, for some purposes, a partnership, and yet be taxed as an association.

We wish to point out here, however, that we are not considering how the particular organization should be classified, but rather, whether the organization has been in fact created. The question of whether a given organization has, in fact, been created, is a matter to be determined by local law. Thus, in *Chisholm v. Commissioner of Internal Revenue* (C.C.A. 2) 79 F.(2d) 14, where the issue was whether a partnership had been formed to sell certain assets and receive the proceeds therefrom, the court determined the question on the basis of the New York partnership law. In *Commissioner of Internal Revenue v. Tenney* (C.C.A. 1) 120 F.(2d) 421, at 423, the court held that no partnership had been created between a husband and wife because, under the applicable Massachusetts law, a married woman could not enter into a contract with her husband. In *The Niles Fire Brick Company*, 6 B.T.A. 8, the question of whether a partnership came into existence was determined on the basis of the law of the state in which the parties lived. In that case the business was inherited by the owners' children who thereafter continued to operate the business. The case holds that under the state law co-

owners who receive a business and continue to operate it automatically become a partnership.

We submit that a careful reading of the cases will show the existence of the Seattle Renton Mill Company partnership, for the purposes of this action, is to be determined by the laws of the State of Washington. The cases which have been cited in appellant's brief demonstrate that the existence of a partnership depends upon intention to create a partnership, which has been clearly shown in this case.

We should also like to call attention to the rationale found in *The Niles Fire Brick Co.*, 6 B.T.A. 8, case. It was there stated that where co-owners receive a business and continue to operate it, they automatically constitute a partnership. In the case at bar we find a valid transfer of all the assets of the corporation to the individual shareholders who thereafter continued to operate the business. On the basis of *The Niles Fire Brick Co.* case, they would automatically constitute a partnership whether or not they ever so intended or agreed.

However, all of the attending facts and circumstances show a settled intention on the part of the shareholders to create a partnership and operate the business after June 30, 1933. The matter, which was discussed and approved, was that the business be transferred from the corporation to a partnership on the 30th day of June, 1933 (R. 53-57). There was unanimous consent to that proposition and by reason of that consent the partnership came into existence. That the business was operated in the form of a partnership after June 30, 1933, can hardly be denied.

Appellee in its brief attempts to deny the existence of the partnership by reference to the tense of certain words in the notice of the shareholders meeting (R. 59) and the resolution of the Trustees (R. 63). The inference which appellee asks the court to draw from these papers is indeed weak. The appellee asks that the recital in the minutes that a sale be authorized to a partnership, "which will be composed" of certain shareholders and "which will be known" by a different name, and the recital in a notice to shareholders that a partnership is "to be formed" be taken to completely negative the demonstrated intention of the interested parties to form a partnership. If this inference is valid, then perhaps we should consider the language of the corporate minutes which read: "* * * and the offer of the said partnership to purchase * * * be accepted * * *" (R. 62), or of the Declaration of Trust (R. 76 at 78), which reads: "I further declare that I have taken said title at the request of the persons interested in the said estate, *who are partners as the Seattle Renton Mill Co.* * * *," or comparable language in the minutes of this shareholders meeting (R. 68) or of the bill of sale (R. 73).

What is perhaps most convincing in determining what the parties intended is the completeness with which the operation was carried on as a partnership. Immediately after June 30, 1933, the names on the signs, stationery, invoices, truck and the like were changed to show the new form of organization (R. 98, 102, 148, 150, 157, 158-161, 117-123). New signature cards were made out (R. 95) and those who asked were advised that a partnership had been

formed (R. 151-152). New books were opened for the partnership (R. 112) and the record shows no action whatsoever by the corporation after June 30, 1933, with respect to the mill operation. It is difficult to understand what else might have been done to more clearly show to the world that the mill business was from June 30, 1933, to be carried on as a partnership. These acts clearly show that the interested parties all intended to be a partnership. They took such steps as they believed were necessary to create a partnership and we submit that all the shareholders, by reason of their assent to the acts done, bound themselves as partners, not by estoppel but by a contract of partnership.

Appellee states the rule in its brief that, for the purposes of taxation, the substance rather than the form of a transaction should determine the question of tax liability. Applying that rule to the case at bar, it clearly appears that, in substance as well as form, the business was carried on by a partnership after June 30, 1933, and we submit that all the objections raised by appellee in this case are matters of form, rather than substance, as for example the technical questions as to the validity of the corporate meetings, corporate notices, and the corporate conveyances.

3. Appellee, on page 17 of its brief, alleges that the partnership had no business purpose and that, since its only purpose was to avoid taxation, the appellant would have to show that it had legally effected the change "beyond any doubt" before the transaction would be recognized for purposes of taxation. Neither

of these assertions is true. The partnership did have an avowed business purpose and that business purpose was to operate the mill. An example of what is meant by an organization being created with no business purpose is found in the case of *Gregory v. Helvering*, 293 U.S. 465, 79 L. ed. 596, 55 S.Ct. 266. In that case the Averill corporation was organized merely to receive a transfer of assets and then dissolve. Its corporate existence continued one day. The court pointed out in that case that the corporation had no business purpose because *it was never intended to operate or function as a business organization.* However, in the case at bar, it cannot be contended that the intention of the parties involved in this case was other than that the partnership should operate the business.

There is no rule which requires that appellant show the change asserted in this case "beyond any doubt" before it can relieve itself of tax liability. The cases cited by appellee in support of that allegation merely held that, where the assets of a corporation are transferred to an individual prior to an ultimate sale to a third person who is actually intended to be the purchaser rather than the intermediate transferee, and where such a transaction is obviously intended to avoid taxation on capital gains, the transaction will be scrutinized with care and must be shown to have been legally accomplished beyond a doubt. The authorities cited by appellee and the holdings of those cases are as follows:

Gregory v. Helvering, 293 U.S. 465, 79 L. ed. 596, 55 S.Ct. 266. In this case, in order to receive assets of a corporation and thus avoid realization of income to

it, the sole stockholder effected a "reorganization" by which the Averill Corporation was organized, received the assets on the purported reorganization and then dissolved, distributing its assets to the sole stockholder. The court held that this was not a reorganization, even though all the legal steps had been taken.

S. A. MacQueen Co. v. Commissioner (C.C.A. 3) 67 F.(2d) 857. Here, the corporation "sold" its assets to a shareholder at an arbitrary figure and he in turn sold them for a great profit, accounting therefor to the other shareholders. In this case the court said the capital gain was that of the corporation.

First National Bank of Greeley v. U. S. (C.C.A. 10) 86 F.(2d) 938; *Mackay v. Commissioner,* 29 B.T.A. 1090; *Jackson v. Commissioner of Internal Revenue,* 39 B.T.A. 937, are also cases involving a dummy purchaser used to reduce realization of income on sale or exchange of assets. The rule of these cases is stated in 2 Mertens, Law of Federal Income Taxation (1942) Sec. 17.06:

> "Many of the cases involving a transfer of assets by a corporation to an individual prior to an ultimate sale to a third person show a desire to avoid taxation. However, in the absence of fraud, such device, if effected by legal means, must be recognized, for the proper avoidance or diminution of a foreseen tax liability is not prohibited. Nevertheless, *such arrangements* are not looked upon with favor and must be carefully scrutinized, and will be approved only when their facts show beyond any doubt the purposes thereof have been legally accomplished."

Since the transfer of the business from the ap-

pellant corporation to the partnership in this case was for the purpose of enabling the partnership to operate the business, and thus reduce income taxation, and not to constitute the partnership a dummy for a preconceived sale to third persons in order to avoid taxes on capital gains, the authorities cited are clearly not in point and we have found no cases which require that appellant prove its case "beyond any doubt" rather than that it merely establish its case by a preponderance of the evidence.

We submit that the evidence shows a settled intention, understanding and agreement by the owners that the business be carried on as a partnership; that each shareholder contributed to the partnership to the extent of his interest in the business and that in law and fact all of the former shareholders of the Seattle Renton Lumber Company became partners doing business as the Seattle Renton Mill Company. We further submit that the uncontroverted evidence shows clearly that appellant corporation received no income after June 30, 1933, and that the judgment of the District Court should be reversed.

Respectfully submitted,

WETER, ROBERTS & SHEFELMAN,
Attorneys for Appellant.